DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 03-0484
Indiana Corporate Income Tax
For the Years 1998 to 2000

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ISSUE

I. **Combined Filing Requirement** – Adjusted Gross Income Tax.

Authority: IC 6-3-2-2(m); IC 6-8.1-5-1(b); Hi-Way Dispatch, Inc. v. Indiana Dept. of State Revenue, 756 N.E.2d 587 (Ind. Tax Ct. 2001); Black's Law Dictionary (7th ed. 1999).

Taxpayer argues that the Department of Revenue – in calculating taxpayer's Indiana income – erred when it recomputed taxpayer's adjusted gross income to reflect on a combined basis all members of taxpayer's federal affiliated group of companies.

STATEMENT OF FACTS

Taxpayer is a Delaware corporation headquartered in Texas. Taxpayer manufacturers paper and paper products. Taxpayer does business in Indiana. Taxpayer owns various subsidiaries.

The Department of Revenue (Department) conducted an audit of taxpayer's business records and tax returns. The audit concluded that taxpayer should be required to file a combined Indiana tax return that included taxpayer's wholly owned subsidiaries. This adjustment to the tax return resulted in an assessment of additional Indiana corporate income tax. The Department sent notices of proposed adjustment which reflected the audit's determination and the consequent, additional tax assessment.

Taxpayer disagreed with the requirement that it file a combined return and with the additional tax assessment. Taxpayer submitted a protest. An administrative hearing was conducted during which taxpayer's representative explained the basis for its protest. This Letter of Findings results.

DISCUSSION

I. **Combined Filing Requirement** – Adjusted Gross Income Tax.

Taxpayer is an out-of-state company which does business in Indiana. Taxpayer owns 100 percent of various subsidiaries. Taxpayer files a consolidated federal income tax return which includes

each member of the affiliated group. Although each member is organized as a separate corporation, the taxpayer (parent company) and the subsidiaries share the same corporate officers.

The audit concluded that the taxpayer and its subsidiaries should be required to file a combined Indiana tax return in order to more fairly reflect taxpayer's Indiana income. The audit determined that the "members of the affiliated group operate a unified, highly integrated worldwide business enterprise for their mutual benefit." The audit concluded that "Indiana income as reported is distorted by inter-company charges for trademark royalties."

The audit refers to royalty payments made by taxpayer to one of its wholly owned affiliates hereinafter referred to as "Delaware subsidiary." The particular business arrangement, by which taxpayer became obligated to pay Delaware subsidiary royalties, began in 1996 when taxpayer – as the owner of certain trademarks, patents, and "know-how" (hereinafter "intellectual property") – granted Delaware subsidiary the right to sublicense that intellectual property.

Thereafter, taxpayer and Delaware subsidiary signed an agreement by which taxpayer was permitted to make use of its own intellectual property. In consideration, taxpayer agreed to pay Delaware subsidiary three percent of its gross sales though the agreement limited the amount of royalties by specifying that the total annual royalty fee paid Delaware subsidiary would not exceed 25 percent of taxpayer's net income for the year. The agreement specified that taxpayer would retain its original ownership of the intellectual property. However, the agreement did not indicate the amount of compensation Delaware subsidiary paid taxpayer for the original right to sublicense the intellectual property; the agreement did not specify if Delaware subsidiary would pay *any* compensation for the right to sublicense the intellectual property.

The audit does not indicate what Delaware subsidiary did with the royalties. The audit did not specifically determine if Delaware subsidiary loaned the royalties back to taxpayer. However, the audit did establish that taxpayer incurred interest charges which were owed Delaware subsidiary. During 1999, taxpayer incurred approximately $153,000,000 in interest charges. During 2000, taxpayer incurred approximately $169,000,000 in interest charges. These interest charges were owed to Delaware subsidiary.

Summarizing, the intellectual property sublicensing/licensing agreement worked like this:

1. Taxpayer owned intellectual property;

2. Taxpayer granted Delaware subsidiary the right to sublicense this intellectual property; Delaware subsidiary apparently paid no consideration for this property;

3. Delaware subsidiary licensed the intellectual property to taxpayer;

4. Taxpayer paid Delaware subsidiary royalties;

5. Taxpayer became obligated to Delaware subsidiary for interest charges.

The audit found that taxpayer should be required to file an Indiana combined return because the royalty and interest payments distorted taxpayer's Indiana income and because "the Taxpayer group functions as one economic entity . . . [and] the members of the group bring synergies to the whole with such advantages unavailable to each company standing alone."

Taxpayer disagrees. Taxpayer states that the Delaware subsidiary has significant substance, has employees, owns property, and that Delaware subsidiary "manages and expands the value of the patent portfolio." Taxpayer states that Delaware subsidiary is an active business with employees and significant assets throughout the United States.

Taxpayer claims that the standard three-factor formula accurately represents taxpayer's income derived from Indiana. In addition, taxpayer maintains that the Department is estopped from requiring that taxpayer file a combined return because the Department – in its previous audits – never suggested such a filing requirement was appropriate.

IC 6-3-2-2(l) vests both taxpayers and the Department with authority to allocate and apportion a taxpayer's income within and among the members of a unitary group of related entities.

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable;
>
> > (1) separate accounting;
> >
> > (2) the exclusion of any one (1) or more of the factors;
> >
> > (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> >
> > (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

It is apparent from the language contained with IC 6-3-2-2(l) that the standard apportionment filing method is the preferred method of representing a taxpayer's income derived from Indiana sources. The alternate methods of allocation and apportionment – including the combined reporting method of which taxpayer complains – are employed when the standard apportionment formula does not fairly reflect the taxpayer's Indiana income.

The Department is prepared to agree with taxpayer's assertion that Delaware subsidiary is more than simply an empty business shell created simply as an imaginative tax shelter. The Department has no reason to dispute taxpayer's contention that transferring its intellectual property to Delaware subsidiary allowed taxpayer to preserve certain federal tax advantages. The Department has no reason to dispute taxpayer's contention that Delaware subsidiary conducts business activities other than simply holding taxpayer's intellectual property. However, the Department is not prepared to attach the same economic substance to the licensing agreement

that taxpayer does. Taxpayer transferred licensing rights to Delaware subsidiary but did so despite the absence of any indication that taxpayer received consideration for doing so. Taxpayer then agreed to pay substantial amounts of annual royalty fees to Delaware subsidiary for permission to exploit the same intellectual property. Taxpayer agreed to pay these royalty fees despite the fact that – by the terms of the parties' own agreement –taxpayer continued to be "the sole owner of the entire right, title and interest in and to the Licensed Trademarks and the goodwill associated therewith . . . ."

Although the audit was not able to determine whether Delaware subsidiary was simply loaning the royalty payments back to taxpayer, taxpayer has not fully addressed the questions raised by its payment of hundreds of million dollars in "interest" payments to Delaware subsidiary.

The audit concluded that taxpayer's licensing agreement, royalty payments, and interest obligations represented taxpayer's attempt to cultivate and harvest tax benefits devoid of any substantive, underlying business purpose. The audit's conclusion on these matters is presumed correct. "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC 6-8.1-5-1(b).

The audit's decision requiring filing a combined return is justified in part under IC 6-3-2-2(l) because the subsidiaries included within the filing – including the Delaware subsidiary – are taxpayer's wholly owned entities; taxpayer and the subsidiaries are "controlled directly or indirectly by the same interests . . . ." The combined filing requirement is justified in part because the royalty payments are derivative of the taxpayer's Indiana business activity; that Indiana activity consists of the marketing of goods bearing taxpayer's trademarks; the value of the goods marketed within the state is attributable in part to taxpayer's patents and taxpayer's "know-how."

Taxpayer has not met its burden of demonstrating that the proposed assessments are incorrect.

In addition to challenging on its face the combined filing requirement, taxpayer argues that it relied on the Department's past acquiescence to the taxpayer's decision to file non-combined returns and that the Department is now estopped from belatedly changing that position. Taxpayer is interposing the defense of "equitable estoppel." Equitable estoppel is a defensive doctrine which "prevents one party from taking unfair advantage of another when, through false language or conduct, the person to be estopped has induced another person to act in a certain way . . . ." Black's Law Dictionary 571 (7th ed. 1999).

Taxpayer maintains that, after having relied upon earlier determinations that taxpayer was not required to file a combined return, the Department may not afterwards back-track on its position to the taxpayer's detriment.

"Equitable estoppel cannot ordinarily be applied against government entities." Hi-Way Dispatch, Inc. v. Indiana Dept. of State Revenue, 756 N.E.2d 587, 598 (Ind. Tax Ct. 2001). However, application of the doctrine against a government entity is not absolutely prohibited. Id. The

exception to this general rule is where "the public interest would be threatened by the government's conduct." Id.

The Department does not agree that it is estopped from requiring that taxpayer and its subsidiaries file a combined tax return. There is no indication that the circumstances which the audit found sufficient to justify its combined filing requirement were the same circumstances present during the previous audits. There is no indication that the Department required or instructed taxpayer to file a separate return but only that the Department acquiesced to the filing of the previous, separate returns. There is no indication that the Department engaged in false, unfair, or deceptive practices which induced taxpayer to arrive at a conclusion that it could indefinitely continue to file separate tax returns. There is no indication that the Department's decision to require a combined return implicates the public's interest.

The Department concludes that taxpayer's estoppel argument is without merit.

FINDING

Taxpayer's protest is respectfully denied.

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